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Important Considerations for Non-Spouse Beneficiaries of Inherited IRAs

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The Individual Retirement Account (IRA) rules are complex when it comes to annual contributions and timing for required minimum distributions (RMDs), let alone the differences between traditional and Roth accounts. The most important decisions and complex rules, however, may fall in the lap of the non-spouse beneficiary of an inherited IRA. This article will discuss the rules and planning opportunities for such beneficiaries.

Married owners of IRAs will typically name their spouse as the primary beneficiary. This is a wise choice as spousal beneficiaries are allowed to rollover the IRA into their account, allowing the IRA to continue to grow tax-deferred until the spouse's RMD period begins at age 70½. Non-spouse beneficiaries do not have the ability to rollover the balance of the inherited IRA into their account, but rather are required to begin taking RMDs soon after the death of the original owner. Before the distribution rules are discussed below, it is important to remember that the advantage of an IRA is that the account balance grows tax-free until distributions are taken, at which point, the distributions are taxed as ordinary income to the beneficiary. With the exception of an immediate need for a distribution greater than the RMD, it is recommended that the assets remain in the IRA and continue to grow, tax-deferred.

The options for when and how a non-spouse beneficiary must take distributions from an inherited IRA depend on the age of the original owner at his death. The original owner of a traditional IRA must begin taking RMDs by no later than April 1st of the year following the year he turns 70½ ("Required Beginning Date"). It should be noted that Roth IRAs do not have RMDs for the original owner but distribution rules for non-spouse beneficiaries are the same for Roth IRAs as traditional IRAs. Different distribution rules for the non-spouse beneficiary apply depending on whether the original owner dies before or after age 70½.

The non-spouse beneficiary has three distribution options when the original account owner dies before age 70½. The first and least recommended option is to take a distribution equal to the full balance of the account. This must be done by December 31st of the following year after the original owner's death. Because there is not an early withdrawal penalty (10% of the distribution amount) for an inherited IRA distribution, the beneficiary will receive the lump sum and will pay only ordinary income tax on the distribution. This is typically not recommended because the full distribution will lose the tax benefits of the tax-deferred growth and may move the beneficiary into a higher income tax bracket.

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The second and third options start with transferring the inherited IRA into an inherited IRA account. Once done, the second option has the beneficiary taking annual RMDs by December 31st of the following year after the original owner's death. For example, if the original owner died in July 2014, the beneficiary must take her first RMD by December 31, 2015. The annual RMD is based on the beneficiary's life expectancy and age as of December 31st. Internal Revenue Service Publication 590 and Treasury Regulation 1.401(a)(9)-9, Q&A-1 provide the single life expectancy divisor. The third option is to defer all RMDs from the inherited IRA until the 5th year after death, at which time a full balance distribution must be made.

For an inherited IRA where the original owner dies after age 70½, the non-spouse beneficiary has two options. The beneficiary may take the immediate full balance distribution or the single life expectancy distributions as discussed above. The beneficiary in this case does not have the 5-year distribution option.

For an inherited IRA with multiple beneficiaries, the account should be divided into separate inherited IRA accounts for each beneficiary. This must be done no later than September 30th of the year following the year of the account owner's death. This allows each beneficiary to make their own distribution decisions. If the inherited IRA is not separated for each beneficiary, annual RMDs will be based on the life expectancy of the oldest beneficiary.

The idea of stretching out an inherited IRA is most beneficial as it will allow the IRA to continue to grow tax-deferred until RMDs are made. Original owners of IRAs may want to consider meeting with the beneficiaries and tax advisors to discuss planning opportunities and wishes of the original owner before the original owner's death. When a non-spouse beneficiary inherits an IRA, whether traditional or Roth, the beneficiary should discuss the distribution options, tax planning, and investment planning with his or her tax and financial advisors.

For more information on inherited IRAs, please contact the tax professionals at Zinner & Co. LLP.